Internal Revenue Service

memorandum

MGDYS-CC:EE:2

date: JUL 30 1991

to: District Counsel, Denver

from: Chief, Branch 2
(Office of Assistant Chief Counsel,
Employee Benefits and Exempt Organizations)

subject: Request for information on fringe benefit issues

This memorandum is in response to your telephone inquiry on Tuesday, July 23, 1991, concerning several issues under section 132 of the Code. The preliminary conclusions in this memorandum are based on the brief facts provided. As you proceed with this matter and identify additional issues or areas of concern, we will be pleased to offer further assistance.

BRIEF SUMMARY OF FACTS PROVIDED:

The City has a number of public facilities which are used for various sporting, cultural, and entertainment events. These facilities are leased to promoters, sponsors, or team owners. As part of its leasing arrangements, the City receives free tickets or season passes to the events which, in turn, the City doles out to its council members. For example, a City council member may be given a season admission pass to a particular stadium or arena, thereby enabling attendance at all events held in the facility. In other instances, the lessee of a City facility may actually send tickets or passes to individuals other than a City council member, but at the request of a council member.

ISSUES:

1) Whether benefits in the form of free tickets, passes or admission provided by the City to its employees constitute taxable income to the employees or, in the alternative, whether the benefits qualify for exclusion as either working condition or de minimis fringe benefits under section 132 of the Internal Revenue Code (Code).

2) If the value of the benefits provided is includible in the gross income of the City employees, whether these amounts constitute wages for federal employment tax purposes (federal income tax withholding and, if applicable, the Federal Insurance Contributions Act (FICA)), thereby obligating the City to withhold and pay federal employment taxes with respect to these amounts.

APPLICABLE LAW - Issue 1

1. Relevant Statutory and Regulatory Background

Section 61(a)(1) of the Code provides that, except as otherwise provided, gross income includes compensation for services including fees, commissions, fringe benefits, and similar items. Section 1.61-21(a)(3) of the Income Tax Regulations[1] provides that a fringe benefit provided in connection with the performance of services shall be considered to have been provided as compensation for services. In addition, section 1.61-21(a)(2) provides that a fringe benefit provided by an employer to an employee is presumed to be income to the employee, unless it is specifically excluded from gross income pursuant to another section of the Code. Such is the case with working condition fringes and de minimis fringes which, under certain conditions, are excluded from gross income pursuant to sections 132(a)(3) and (a)(4), respectively.

Section 132(d) of the Code defines the term "working condition fringe" as any property or services provided to an employee of the employer to the extent that, if the employee paid for such property or services, such payment would be allowable as a deduction under section 162 or 167. In other words, the value of a fringe benefit generally may not be excluded unless the employee could have deducted the expense under section 162 had he paid for it himself.

In no event, however, may the value of property or services provided to an employee be excluded from the employee's gross income as a working condition fringe, unless the applicable substantiation requirements of either section 274(d) or 162 (whichever is applicable) and the regulations thereunder are satisfied.[2] See § 1.132-5(a)(1)(ii) and (c).

Under section 132(e) of the Code, the term "de minimis fringe" is defined as any property or service the value of which

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[1] The final fringe benefit regulations, which were issued on July 6, 1989, are effective as of January 1, 1989. The temporary fringe benefit regulations were issued on December 23, 1985, and are effective from January 1, 1985, to December 31, 1988, with respect to fringe benefits provided before January 1, 1989.

[2] The substantiation requirements are satisfied "by adequate records or by sufficient evidence corroborating the [employee's] own statement." Section 1.274-5T(c)(1); see also 1.162-17(d). Thus, an employee must be able to substantiate the excluded amounts through records and other evidence.

is (after taking into account the frequency with which similar fringes are provided by the employer to the employer's employees) so small as to make accounting for it unreasonable or administratively impracticable.

The special rule for de minimis fringe benefits is essentially intended to give administrative relief to employers when the costs associated with accounting for the benefit would exceed the nominal tax revenue generated by including the value of the benefit in income. The examples in the legislative history to section 132(e) of the Code demonstrate that the exclusion for de minimis fringe benefits is limited to situations in which the benefit is small in value and provided infrequently:

> For example, benefits which generally are excluded as de minimis fringes include the typing of a personal letter by a company secretary, occasional personal use of the company copying machine, monthly transit passes provided at a discount not exceeding $15, occasional company cocktail parties or picnics for employees, occasional supper money or taxi fare for employees because of overtime work, and certain holiday gifts of property with a low fair market value.

H.R. Rep. No. 861, 98th Cong., 2d Sess. 1168 (1984).

In contrast, section 1.132-6(d) of the regulations lists season tickets to sporting or theatrical events as an example of a fringe benefit that is not excludable as "de minimis."

Section 132(j) of the Code provides that section 132 (other than subsection (e)) shall not apply to any fringe benefits of a type the tax treatment of which is expressly provided for in any other section of Chapter 1 of Subtitle A.

2. Provider/Recipient of Fringe Benefits

The issue of who may be treated as a provider or recipient of a fringe benefit for purposes of taxing the benefit is addressed in the regulations under section 61 of the Code. Section 1.61-21(a)(4)(i) of the regulations provides that a taxable fringe benefit is included in the income of the person performing the services in connection with which the fringe benefit is furnished. Generally, the person performing the services is the same person receiving the benefits. However, the regulations specify that a fringe benefit may be taxable to a person, even though that person did not actually receive the benefit. If a fringe benefit is furnished to someone other than the service provider, such benefit is considered to be furnished to the service provider and use by the other person is considered to be use by the service provider.

In addition, section 1.61-21(a)(4)(ii) defines "employees" broadly to include any person performing services in connection with which a fringe benefit is furnished, unless otherwise provided. Thus, the person to whom a fringe benefit is taxable need not be an employee of the provider of the fringe benefit, but may be, for example, a partner, director, or an independent contractor.

Equally broad in its reach is the definition of "employer" in section 1.61-21(a)(5) of the regulations. The "provider" of a fringe benefit is that person for whom services are performed, regardless of whether that person actually provides the fringe benefit to the recipient. The provider of a fringe benefit need not be the employer of the recipient of the fringe benefit, but may be, for example, a client or customer of the employer or of an independent contractor. For convenience, the term "employer" includes any provider of a fringe benefit in connection with payment for the performance of services, unless otherwise provided.

3. Valuation of Fringe Benefits

The regulations provide that an employee must include in gross income the amount by which the fair market value of the fringe benefit exceeds the sum of (1) the amount, if any, paid for the benefit by or on behalf of the recipient, and (2) the amount, if any, specifically excluded from gross income by another section of the Code. Section 1.61-21(b)(1).

An employee always has the option of reimbursing his employer for a fringe benefit. Assuming that the employee does not pay anything for the benefit, the amount subject to inclusion will depend on the extent to which the value of the benefit is specifically excluded by some other section of Subtitle A of the Code. Section 1.61-21(b)(1). For example, once benefits which qualify as working condition fringes under section 132(d) are subtracted from the total benefits provided by the employer, the remainder will represent the amount which must be included in gross income.

ANALYSIS - Issue 1

In order for free tickets and season passes to be excludable from a City council member's gross income as working condition fringes under section 132(d), the benefits must be allowable as deductions under section 162 of the Code. Under section 162(a), a taxpayer engaged in business can deduct all ordinary and necessary business expenses which are incurred in that business. Welch v. Helvering, 290 U.S. 111, 113 (1933). To be "ordinary," an expense must be customary or usual within the experience of a particular trade, industry, or community. Id. To be "necessary"

to a taxpayer's business, an expense must be more than remotely or incidentally connected with the business. Larrabee v. Commissioner, 33 T.C. 838, 843 (1960).

For purposes of section 162, the definition of "business" includes services of an employee; thus, any expenses incurred by an employee may be deductible if they meet the requirements of section 162. In addition, section 7701(a)(26) provides that the performance of a public office is included in the term "trade or business."

Thus, the problem in this case is not whether a City council member, as an elected official, performs functions that would qualify as a trade or business, but whether there is a basis under section 162(a) for allowing the deduction as "ordinary and necessary" expenses of that trade or business.

In Rev. Rul. 84-110, 1984-2 C.B. 35 (copy enclosed), a city council member incurred expenses for staff salaries, office rent, and office supplies, which the member paid for out of personal funds. The ruling holds that the expenses were made to permit the council member to properly perform the duties of his office. Therefore, the payments were deductible under section 162(a) of the Code provided the city council member itemizes deductions.

Rev. Rul. 73-356, 1973-2 C.B. 31 (copy enclosed), addressed issues concerning newsletters published and distributed by U.S. Congressmen. On the issue of expenses incurred in issuing newsletters to constituents, the ruling holds that the performance of the official duties of a Congressman in his trade or business as an elected official includes keeping his constituents informed with respect to the affairs of the Federal Government. Therefore, the amounts expended in issuing such publications are ordinary and necessary business expenses within the meaning of section 162(a) of the Code and are deductible provided the Congressman itemizes his deductions.

In no event, however, are expenses incurred while running for office or conducting a campaign for public office treated as ordinary and necessary expenses under section 162(a) of the Code. See section 162(e)(2)(A) of the Code and § 1.162-20 of the regulations.

We understand that some council members have asserted that use of the tickets enables them to attend sporting, cultural, and entertainment events to perform their oversight activities of municipal facilities. Based on the brief facts provided, we believe that the expenditures might not be deductible as ordinary and necessary business expenses, if the council members had purchased the tickets themselves for these purposes. These expenditures do not fall into those categories specifically

included as deductible expenses under section 162(a) (i.e., they do not qualify as travel expenses, compensation for services, or rentals incurred in carrying on a trade or business). Thus, the issue is whether the expenditures would fall within the other general areas of ordinary and necessary expenses under section 162(a). As stated above, we are unable to determine at this point in the inquiry whether the purchase of the tickets or passes, or any portion thereof, would qualify as ordinary and necessary business expenses.

Even assuming that a taxpayer's expenses meet the requirements of section 162(a) (i.e., the expenses are necessary to the taxpayer's business), the expenses are disallowed if they are also personal, living, or family expenses. Section 262; Reading v. Commissioner, 70 T.C. 730 (1978), aff'd 614 F.2d 159 (9th Cir. 1980). In distinguishing between deductible business expenses and nondeductible personal expenses, the essential inquiry is whether a sufficient nexus exists between the expenses and carrying on a taxpayer's trade or business, or whether the expenses are essentially person in nature. Kowalski v. Commissioner, 65 T.C. 63 (1975), rev'd on other grounds 544 F.2d 686 (3d Cir. 1976), rev'd 434 U.S. 77 (1977). Where both sections 162(a) and 262 apply to an expense, section 262 takes priority and the expense is not deductible. Sharon v. Commissioner, 66 T.C. 515, 522-23 (1976), aff'd per curiam 591 F.2d 1273 (9th Cir. 1978), cert. denied 442 U.S. 941 (1979).

In addition, even if expenditures of the type proposed would qualify as ordinary and necessary expenses and, therefore, would be excludable under section 132(d), there may be a problem of substantiation under section 274(d). If the employee is unable to substantiate the excluded amounts through adequate records and other evidence, the value of the benefits may not be excluded. See section 1.132-5(c) of the regulations.[3]

From the facts provided, the benefits also do not qualify for exclusion under the de minimis exception of section 132(e).

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[3] It does not appear that the council members have asserted that the purchase of tickets and passes would be expenditures related to activities of a type generally considered to constitute "entertainment, amusement, or recreation," thereby bringing into the question the applicability of section 274(a). For a deduction to be allowed for any item under section 274(a)(1)(A), the taxpayer must establish that the item was directly related to the active conduct of the taxpayer's trade or business or, in the case of an item directly preceding or following a substantial and bona fide business discussion, that such item was associated with the active conduct of the taxpayer's trade or business.

If a ticket or pass were provided to a City council member on an infrequent basis and if the value of these benefits were small, perhaps the benefits would qualify for exclusion. However, we believe that the practices you described exceed the de minimis level contemplated by the statute.

On the issue of taxation, the value of benefits is taxable to the council members as employees of the City. The City as employer provides the benefits to its employees in connection with their performance of services for the City. Even if the City did not directly issue the tickets to the council members (i.e., the tickets by-pass the City and are issued to the council members by a team owner), the City would be treated as the provider of the benefits under the regulations because the City is the entity for whom the council members perform services. In addition, as long as the benefits are provided in connection with a council member's performance of services for the City, the free tickets are taxable to that council member, even if the benefit is not actually used by the council member or is not received by the council member but directed to another for use.

At this time, we are unable to address the question of valuation. We have previously provided your office with a copy of a technical advice memorandum which addressed the issue of valuing a fringe benefit when a portion of the benefit is excludable as a working condition fringe. Once additional information is available, we will be available to provide additional assistance.

APPLICABLE LAW - Issue 2

1. Relevant Statutory and Regulatory Background

For purposes of FICA, section 3121(b)(7) of the Code and section 31.3121(b)(7)-1 of the employment tax regulations generally exclude from "employment" any service performed in the employ of a state, any political subdivision of a state, or any wholly-owned instrumentality of one or more states or political subdivisions.[4] However, certain services by a government employee cannot be excluded from "employment" for purposes of FICA under section 3121(b)(7). For example, section 3121(b)(7)(E) provides that service covered by an agreement under section 218 of the Social Security Act (which permits a government entity to elect social security coverage for groups of its employees) is not excludable from "employment" FICA purposes.

[4] See also the exception from the definition of "employment" set forth in section 3306(b)(7) for FUTA purposes.

In addition, section 11332(b) of the Omnibus Budget Reconciliation Act (OBRA) of 1990, Pub.L. 101-508, recently added subparagraph (F) to section 3121(b)(7). Under section 3121(b)(7)(F), service in the employ of a state, any political subdivision of a state, or any wholly-owned instrumentality of one or more states or political subdivisions by an individual who is not a member of a retirement system of the state, political subdivision or instrumentality is not excludable from "employment" for FICA purposes, wages paid for such service are subject to old-age, survivor, and disability insurance (OASDI) taxes. This new provision, which applies to services performed after July 1, 1991, also applies to hospital insurance tax with respect to the wages of those employees (not otherwise already subject to the hospital insurance tax) who become subject to OASDI taxes by reason of section 3121(b)(7)(F).[5]

Assuming for this discussion that the services performed by the City council members are not excludable from "employment" for purposes of FICA, the next issue is whether the benefits provided are included in the definition of "wages." Sections 3121(a) and 3401(a) of the Code and sections 31.3121(a)-1(b) and 31.3401(a)-1(a)(1) of the Employment Tax Regulations provide that, for purposes of FICA and federal income tax withholding, the term "wages" means all remuneration for employment with certain specified exceptions.[6]

For purposes of FICA and federal income tax withholding, sections 3121(a)(20) and 3401(a)(19) of the Code, respectively, provide exceptions from the definition of "wages" for any benefit provided to an employee if at the time the benefit is provided it is reasonable to believe that the employee will be able to exclude the benefit from income under section 132. See also

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[5] Prior to the enactment of section 3121(b)(7)(F) by OBRA 1990, section 13205(a) of the Consolidated Omnibus Budget Reconciliation Act (COBRA) of 1986, Pub.L. 99-272, had amended section 3121(u) of the Code to provide an exception to section 3121(b)(7), thereby subjecting the services of certain state and local government employees to Medicare taxes under sections 3101(b) and 3111(b) of the Code. As a result, services performed by state and local government employees not subject to a section 218 agreement are "employment" for Medicare tax purposes unless the continuing employment exception of section 3121(u)(2)(C) applies. See also Rev. Rul. 86-88, 1986-2 C.B. 172, and Rev. Rul. 88-36, 1988-1 C.B. 343.

[6] Sections 3306(b) of the Code and 31.3306(b)-1(b) of the employment tax regulations provide a similar definition of "wages" for FUTA purposes.

sections 31.3121(a)-1T and 31.3401(a)-1T of the temporary regulations.[7]

To understand the exceptions set forth in sections 3121(a)(20) and 3402(a)(19) of the Code, a review of the legislative is helpful.

Section 531 of the Deficit Reduction Act of 1984 (DEFRA) amended section 61(a) of the Code to include "fringe benefits" in the definition of gross income.[8] Pub.L. 98-369. In addition, DEFRA added section 132 to the Code which provided a statutory approach for determining which employer-provided benefits should be excluded from income. The corresponding change to the employment tax provisions resulted in the addition of sections 3401(a)(19), 3121(a)(20), and 3306(b)(16) to the Code. The legislative history accompanying the enactment of these provisions sets forth their purpose as follows:

> [T]he conference agreement sets forth statutory provisions under which (1) certain fringe benefits provided by an employer are excluded from the recipient employee's gross income for Federal income tax purposes and from the wage base (and, if applicable, the benefit base) for purposes of income tax withholding, FICA, FUTA, and RRTA, and (2) any fringe benefit that does not qualify for exclusion under the bill and that is not excluded under another statutory fringe benefit provision of the Code is includible in gross income for income tax purposes, and in wages for employment tax purposes, at the excess of its fair market value over any

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[7] Sections 3306(b)(16) of the Code and 31.3306(b)-1T of the temporary employment tax regulations provide similar exceptions from the definition of "wages" for purposes of FUTA.

[8] On September 5, 1975, Treasury published a discussion draft of regulations proposing to prescribe standards for determining the tax treatment of fringe benefits. In response, Congress precluded the Service from issuing regulations or rulings altering the tax treatment of nonstatutory fringe benefits. Pub.L. 95-427, § 1 (1978); Pub.L. 96-167, § 1 (1979); Pub.L. 97-34, § 801 (1981). Following the expiration of the moratorium extended by the Economic Recovery Tax Act of 1981, Pub.L. 97-34, Treasury announced that the Service, pending Congressional action, would refrain from issuing regulations or rulings in the area and, accordingly, would not change its existing administrative practice prior to January 1, 1985. On July 18, 1984, Congress enacted section 531 of the Deficit Reduction Act of 1984, Pub.L. 98-369, that amended section 61(a) of the Code to include "fringe benefits" in the definition of gross income and added section 132 to the Code, effective January 1, 1985.

> amount paid by the employee for the benefit. The latter rule is confirmed by clarifying amendments to Code sections 61(a), 3121(a), 3306(b), and 3401(a) and section 209 of the Social Security Act.

H.R. Rep. 861, 98th Cong., 2d Sess. 1169, 1984-3 (Vol. 2) C.B. 1, 423.

As set forth in the legislative history, these provisions are intended to change prior law. As a result of DEFRA, only if the employer reasonably believes that the fringe benefit will be excludable from the gross income of the employee under section 132 may the fringe benefit be excluded from wages for employment tax purposes.

The exclusion from wages found in sections 3121(a)(20) and 3401(a)(19) is not triggered merely by an employer's assertion that it applies. If an employer seeks to rely on the exclusion, it is obligated to have, at minimum, an understanding of the law and to apply the law to the particular facts. In this way, the existence of a reasonable belief for excluding the benefits is based on a reasoned judgment.

ANALYSIS - Issue 2

As discussed in Issue 1, we believe that the benefits described are not excludable from gross income under section 132 of the Code. Thus, we conclude that the benefits are provided in connection with the performance of services and, therefore, are wages for purposes of FICA, FUTA and federal income tax withholding. Only if it were reasonable for the employer to believe that the benefits were excludable under section 132 will the benefits be excludable from the definition of "wages." Under the circumstances you have described, it appears that the employer did not have a reasonable belief that the benefits were excludable based on a reasoned judgment. Thus, the City should have withheld federal income tax and, assuming that the city council members' services are not excepted from "employment" under section 3121(b)(7) of the Code, the City should have withheld the employee portion and paid the employer portion of the FICA tax with respect to the value of the benefits.

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